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Report from Arizona 2005: Coverage of Selected Sessions of ABS West 2005

14 February 2005

ABS West 2005 reflected the generally positive outlook of securitization professionals. Although many market participants expect a modest decline in issuance volumes in 2005, they anticipate that issuance levels will remain well above those of 2003. In addition, they expect interest rates to rise only moderately and to remain below levels that would create difficult stresses for ABS.

However, against the backdrop of confidence, many panelists noted the potential for problems if the economic environment shifts in unexpected ways. Their concerns were essentially the same ones that captured the spotlight at ABS East 2004 last October. They mentioned the possibility of declining home prices and the risk that interest rates rise more quickly than expected. In addition, various panelists expressed continuing concern over the growing prevalence of interest-only sub-prime mortgage loans.

On the regulatory front, the headline item was the new Regulation AB from the SEC. Panelists repeatedly emphasized that 2005 will be a year of hard work (and long hours) for the professionals who are responsible for implementing procedures to comply with the new SEC rules. Accounting and risk-based capital issues also received appropriate attention.

Panelists generally applauded the improved transparency that they expect to come from the SEC's new rules. Some panelists also highlighted fraud risk and "integrity" as areas where the market has recently made progress. With luck, continuing improvements in both transparency and integrity will be the hammer and anvil from which the structured finance community will forge a better and stronger securitization market for the future.

The following summaries reflect remarks of the panelists who participated in selected sessions at the ABS West 2005 conference sponsored by Information Management Network. For the most part, the summaries have been drawn from notes taken during the sessions by Nomura employees. The summaries have not been reviewed or approved by the panelists. While we have tried to capture panelists' remarks accurately, we apologize in advance for any inaccuracies and omissions. In addition, we wish to acknowledge the excellent work of the conference organizers in hosting the conference.

The summaries below do not necessarily reflect the views of Nomura Securities International or any of its subsidiaries or affiliates.

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Contacts:
Mark Adelson
(212) 667-2337
madelson@us.nomura.com

Nomura Securities International, Inc.
Two World Financial Center
New York, NY 10281-1198

www.nomura.com/research/s16

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Monday, 7 February 2005

12:15 pm – Stepping Back from Deal Flow: ABS Forecast 2005

Supply of Credit: Lenders and securitization issuers have ample capacity to provide increasingly more credit to borrowers. Lenders and securitization issuers compete primarily on structure and loan terms. They compete less on price (interest rates). Investors have seemingly endless appetite for new securities, which keeps credit cheap for borrowers.

Surveillance becomes increasingly important as deals contain weaker assets and as they use aggressive structural features. New products help investors with surveillance. One example is ABS Deal Monitor℠ from Structured Finance Analytics.

Sub-prime Mortgage ABS: Sub-prime mortgage loans were the hot ABS asset class in 2005. There is a trend toward "affordability products" with lower monthly payments. Key examples include the growing prevalence of interest-only (IO) mortgage loans and loans with 40-year amortization schedules. Slowing home price appreciation may pose a threat to the sub-prime mortgage sector. Rising interest rates and available funds caps in sub-prime mortgage ABS pose another potential challenge to the sector.

Regulation AB: New Regulation AB[1] from the SEC is a key development. From an investor's perspective, four key points include the following: (1) prospectus "non-delivery," (2) materiality, (3) static pool data, (4) improved disclosure. The first point relates primarily to the timing of information delivery and the nature of the information that an investor receives by the time he makes an investment decision. The new regulations rely heavily on the notion of "materiality" – the standard for determining whether an issuer must disclose certain information based on whether investors would think it is important. In a major break from prior practice, the new regulations require issuers to disclose performance data on their past securitizations or asset originations. In addition, the new regulations require expanded disclosure in many other areas.

Reporting: Investors now scrutinize the quality of reporting by ABS and ABCP issuers. Investors focus closely on a deal's subject assets, regardless of the credit quality of the issuer/sponsor. A declining proportion of new deals use "agreed upon procedures" reports[2] from an accounting firm as

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[1] 17 C.F.R. §§ 229.1100-1123 (adopted in Release 33-8518, 70 Fed. Reg. 1506 at 1597-1614 (7 Jan 2005), available at http://www.sec.gov/rules/final/33-8518fr.pdf).

[2] *See generally* SEC Release 33-8419, 69 Fed. Reg. 26650 at 26697-98 & n.257 (13 May 2004) (available at http://www.sec.gov/rules/proposed/33-8419.pdf)

the main way to verify the reliability of servicing reports. Compared to older deals, reporting and monitoring requirements in newer deals provide for delivery of much more information. New reporting requirements increase the cost of servicing and reporting. Third-party servicers likely will start demanding higher fees. Many ABS issuers lack the ability to comply with new reporting obligations and will have to get help from third party service providers. Areas where ABS issuers may face challenges include the following:

- accounting for residuals of deals backed by home equity lines of credit (HELOCs),
- determining net cash recoveries in deals backed by distressed credit card receivables (must net out payments to collection agencies from gross cash collections),
- dilution in trade receivables deals (because dilution may be concealed in contingent liabilities or other expenses), and
- in timeshare deals: (1) contract reconciliations between the seller and servicer, (2) cash accounting in a complicated waterfall, (3) accounting for defaulted contracts.

The market is likely to use third-party teams more often to analyze ABS collateral in 2005 and beyond.

Flow Trader's Perspective: Public ABS issuance volume grew significantly in 2004, driven by continuing demand for consumer credit, low interest rates, strong home price appreciation, and a favorable economy. Floating rate issuance dominated in 2004. In the sub-prime mortgage area, 90% of last year's issuance was floating rate.

The overall supply of new ABS deals is likely to be flat or to decline slightly in 2005. The supply of mortgage-related ABS is likely to decline slightly. The supply of ABS backed by auto receivables and credit card receivables is likely to grow slightly. Financing activity by the Big Three automakers and credit card ABS refinancings will be the key drivers of non-mortgage ABS issuance volumes in 2005. Student loan ABS issuance is likely to be slightly higher. Market technicals (i.e., declining supply) favor tighter spreads across the board. The best relative value is in five-year fixed-rate tranches and last-cash flow tranches of sub-prime mortgage deals. Long-WAL (weighted-average life) tranches from student loan deals are attractive also.

2:15 – CDO Analytics and Taxation for Investors

An investor analyzing a CDO must consider credit risk, interest rate risk, currency risk, prepayment risk, structural risk, and manager risk. Analytical tools work for some of those risks, but not all of them. CDO tranches that carry triple-A ratings are not all the same. Most investors focus on estimated defaults and recoveries, but those items don't tell the whole story.

Credit Risk: Timing of defaults can have an important impact in modeling the risk of a CDO. The "default rate" may be an ambiguous concept because it may refer to an annual rate or a cumulative rate over the life of a portfolio. Timing of recoveries is important. Slow recoveries cost more.

Interest Rate Risk: Even if both assets and liabilities are floating rate, interest rate risk is important because defaulted assets do not pay interest. Rating agency stresses for interest rate risk generally are reasonable. Interest rate hedges can cause problems if risk is over- or under-hedged. CDO offering documents generally do not disclose hedge schedules. Investors should ask for hedge schedules.

Prepayment Risk: How accurate is the amortization schedule for the portfolio? What happens when assets prepay? Are proceeds reinvested or used to amortize liabilities?

Structural Risk: Structural risk is a catch-all category. The details of a CDO's waterfall are extremely important. Poor performance may impose trading restrictions. Call dates are important.

Manager Risk: Manager risk is hard to quantify. One approach is to adjust assumed recovery rates upward or downward based on the quality of the manager. Some managers "game" structures to the detriment of investors.

Models are only tools and may not tell the whole story of a deal. Investors can ask whether the model of a given deal on a vendor system (e.g., Intex or Derivative Solutions) has been "tied out" to the underwriter's model. Users of models should carefully scrutinize inputs and understand what the inputs do. Investors should compare model results to "back of the envelope" calculations in order to make sure that model results make sense.

Issues in Modeling CDOs: CDO analysis starts with getting loan-level information from which to assign default, recovery, and prepayment assumptions. Collateral information must be up to date and complete. CDO collateral is non-homogeneous. Properly modeling a CDO requires understanding each of the underlying securities. For example, if a CDO is backed by sub-prime mortgage ABS, it may be necessary to drill down to the loan group level within each of the underlying securities and to assign specific prepayment, default, and recovery assumptions to each loan group. Other inputs also are important, such as interest rate assumptions.

Given meaningful assumptions about the properties of a CDO's underlying collateral, it is possible to properly analyze a CDO with a model. [note: A challenge in using the models is that different reasonable assumptions sometimes can produce very different results. It may be impossible for users of a model to determine whether they have chosen assumptions that most accurately reflect the real world.]

One modeling approach is to use Monte Carlo simulations that vary default rates with each path. This permits analysis of projected losses for each scenario. A useful output of a model is the CDR (constant default rate) that causes the first dollar of loss for a tranche.

3:30 pm – Who Put the "Alt" in Alt-A[3]

There are really three kinds of alt-A collateral: (1) prime alt-A, (1) alt-A-minus, and (3) alt-B or "sub-prime alt-A." Fitch made that finding after analyzing several years' worth of alt-A deals and collateral from RFC's RALI shelf and from IndyMac's RAST shelf. The analysis used 90-day delinquencies as a proxy for default and traced key characteristics such as borrower FICO scores and LTVs.

Fitch considered three bands of FICO scores: <670, 670-699, and ≥700. Fitch found that RALI loans in each FICO band displayed better credit performance than loans from the RAST shelf. Fitch also found that RALI loans displayed better credit performance than RAST loans for different LTV bands. Fitch found that the occupancy status of properties securing loans was strongly correlated to credit risk. Loans on non-owner occupied properties performed significantly worse than loans on owner-occupied properties.

In addition to tangible drivers of performance (LTV, FICO score, occupancy status, loan purpose, etc.), Fitch believes that there are intangible factors that drive loan performance. Those factors include origination practices such as appraisal practices, FICO sourcing, and the particulars of how a borrower's debt-to-income ratio is calculated (e.g., including or excluding medical expenses). Practices can be materially different from one issuer to another and those differences can materially drive performance. The key is to understand how an issuer originates its collateral.[4]

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[3] *See* Ghosh, S, et al., *Who Put the "Alt" in Alt-A?*, Fitch special report (11 Oct 2004).

[4] Fitch's report stated the findings as follows:

> The chart below illustrates Fitch's belief that performance will vary depending on the origination practices and controls of the underlying lender of Alt-A loans. As illustrated by the chart below, even after controlling for the key drivers of risk, the RALI and RAST loans performed quite differently. Hence, there are factors beyond the visible loan attributes that affect performance. In a nonhomogenous sector, especially one that continues to evolve, these lender-specific intangibles are of great importance in discerning differences in embedded risks and credit performance. The

Credit enhancement levels are different for the three categories of alt-A mortgage loans. Credit enhancement for "prime alt-A" loans is in the range of 4% to 4.5% for AAA and in the range of 1% to 1.25% for BBB. Credit enhancement for "alt-B" loans is roughly 11% for AAA and 1.75% for BBB, though there have been few deals backed primarily by alt-B loans The "alt-A-minus" category has credit enhancement in the range of 9% to 10% for AAA.

From the perspective of an investor who buys senior tranches, consistency of collateral over time is very important. It allows the investor to develop confidence in stable credit quality (and the credit enhancement levels) and to focus on prepayment issues. Alt-A securities are attractive because they have favorable convexity properties compared to regular mortgages (i.e., less prepayment risk). Consistency of collateral allows development of alt-A "branding" through which investors can develop confidence in the whole alt-A story for a given issuer.

Several years ago, alt-A loans were primarily defined by reference to specific loan characteristics, such as property use (e.g., vacation home, investment property) or LTVs above certain thresholds. Today, the market defines alt-A to include virtually any loans with underwriting exceptions that can give them favorable convexity characteristics.

Investors look at alt-A production on an issuer-by-issuer basis. Some issuers are very consistent in the collateral that they produce and some are erratic. Others, particularly conduits, produce deals with more erratic results.

Investors can find greater values in deals from issuers who produce consistent production. Investors also can find value in one-off conduit deals, but they must analyze those deals more closely. Bloomberg is not a sufficient tool for analyzing collateral in one-off deals. LoanPerformance.com is a good source of data and analytics for analyzing those deals.

Tuesday, 8 February 2005

8:15 am – ABS Bowl 2005: 1st and 10 or 4th and Long?

Despite predictions to the contrary, global structured finance issuance continued to grow in 2004, driven largely by high volumes in residential MBS and sub-prime mortgage ABS. Moody's predicts that global structured finance issuance volume will be flat to slightly declining in 2005. Moody's expects the U.S. ABCP outstandings will grow slightly in 2005. Last year's issuance volume of home equity ABS was greater than all term ABS issuance in 2002. Moody's expects non-home equity ABS sectors to grow somewhat in 2005.

> intangibles, including the underwriting process and controls, valuation procedures, sourcing of credit variables, exception policies, and operational effectiveness, among others, manifest themselves through performance measures (e.g. delinquency status and pool losses) for the issuers, even though there are no apparent distinctions in the underlying risk characteristics (visible loan attributes) of the collateral pool. Fitch regards the understanding of a lender's origination practices as instrumental in grasping the credit risks associated with this expanding product segment. Controls around underwriting decisions and exceptions, valuation type, pre- and post-funding reviews, and sourcing will continue to drive loan performance. The importance of the distinction between issuers and its impact on transaction performance will be discussed in detail in a forthcoming Fitch special report on how to evaluate seller/servicers for RMBS transactions.

Id. at 4-5. Interestingly, Moody's view seems to be moving in the opposite direction:

> These streamlined processes, and improved technology infrastructure, ensure tighter control over originations and servicing. Lenders striving to produce pools of uniform risk are able to succeed consistently. Although Moody's continues to believe that differences in originator practices and loan programs have the potential to have a large influence on loan performance, beyond that predictable by any quantitative model, we also believe that lenders' efforts toward best practices and uniform risk across deals will create a large subset of pools that can be assessed through a largely quantitative model. **Specifically, Moody's has refined its RMBS model for that set of large, geographically diverse Jumbo A and Alt-A pools from established originators and rated servicers to the point of delegating the bulk of the determination of these credit support levels to the model.** The home equity market has not progressed sufficiently to so delegate those rating decisions.

See Seigel, J., *Moody's Mortgage Metrics: A Model Analysis of Residential Mortgage Pools*, Moody's special report at 2 (1 Apr 2003) (emphasis in original, footnotes omitted).

What are the Field Conditions for 2005? One panelist expects the Fed to raise the Fed Funds rate to 3¼%. Spreads are very tight. Corporate spreads are at all-time tights. ABS spreads tend to move in sympathy with corporate or RMBS spreads. Favorable economic conditions help keep spreads tight. One panelist expects spreads to remain stable in the near term, with a bias toward widening in the second half of the year. A sudden widening should only happen if there is an exogenous shock.

A second panelist expresses greater uncertainty about interest rates. He is concerned about sluggish job growth. He feels that the market has reached a peak and that spreads are very tight. He expects spreads to continue to grind tighter. Investors should focus on the issue of home price appreciation in the sub-prime ABS sector. Investors should exercise caution under current market conditions.

A third panelist expects spreads to remain very tight and expects long-term interest rates to rise. He expects continuing demand from Asia to exert a strong technical influence on the U.S. ABS market. He also expects the growing U.S. budget deficit to become an important factor for the ABS market. Fed Chairman Greenspan's retirement in January 2006 creates uncertainty. Investors should favor short-term positions.

A fourth panelist expects rising interest rates to create pressure on real estate ABS. Housing affordability is at the lowest point in three years, but not very low in a longer-term context. Declining rates of home price appreciation could become a problem. He poses the question of whether the recent high rates of home price appreciation actually increase the likelihood that home prices may decline in certain areas. He argues that new deals should have much more credit enhancement than older deals.

A fifth panelist expects short rates to go to 3½%. He notes that short rates exert a strong influence on credit card securitization activity.

A sixth panelist focuses on the shape of the yield curve over the past three years. He feels that the shape of the yield curve has strongly boosted demand over the past three years. The steepness of the yield curve has boosted demand from CDOs. The past few years brought a huge influx of "carry trade" players, whose entry into the market has pushed spreads tighter. When the yield curve flattens, demand in the ABS market is likely to decline substantially. The panelist warns that investors should consider how prepayments have saved many sub-prime mortgage ABS that otherwise would have experienced downgrades or defaults on some of their tranches. Declining prepayments in a higher-interest rate environment could lead to worse credit performance going forward.

Rule Book Changes: New Regulation AB[5] from the SEC codifies many details of disclosure practices for ABS. However, some questions remain. The SEC has instituted a pilot program to help issuers work through the issues. Firms are building systems to support the requirements of Sarbanes-Oxley certifications. The Basel risk-based capital framework will require some banks to hold more capital in respect of some activities while allowing them to hold less capital related to highly-rated ABS investments.

An issuer panelist notes that his company is already revising its disclosure practices to accommodate Regulation AB. His company seems inclined to resist disclosure of borrower FICO scores.

Going Long – New Asset Classes and Market Growth: One panelist expects continued growth in the area of insurance reserve deals (sometimes called "Regulation XXX" deals).[6]

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[5] 17 C.F.R. §§ 229.1100-1123 (adopted in Release 33-8518, 70 Fed. Reg. 1506 at 1597-1614 (7 Jan 2005), available at http://www.sec.gov/rules/final/33-8518fr.pdf).

[6] *See generally*, Cummins, J.D., *Securitization of Life Insurance Assets and Liabilities*, Wharton Financial Institutions Center, Working Paper No. 04-03, at pp. 39-40 (3 Jan 2004) (available at

A second panelist observes that, over the whole history of the ABS market, many "new" asset classes failed to perform as advertised. Now, investors remember those lessons and view new asset classes with greater skepticism. The key underlying notion of securitization is the desire to separate the performance of ABS from the business fortunes of a deal's sponsor. However, it has become clear that some linkage persists in many types of deals.

A third panelist expects middle-market loans to be an emerging asset class in 2005. He also expects increased activity in selling tranches that carry speculative-grade ratings. Issuers will have the opportunity to sell a greater portion of their retained interests.

A fourth panelist notes that three factors drive spreads: (1) supply & demand, (2) fear & confidence, and (3) fundamentals. The events of the past year show that fear & confidence can be a strong factor. The tightening of the Metris credit card ABS is a vivid example: the "C" tranches tightened from discount margins of 2,500 bps to 200 bps. He feels that some pooled aircraft ABS that can be purchased at deep discounts now represent good value.

The "Other" Football – What's Happening Internationally: One panelist notes that competition in Europe has increased in the credit card sector. Credit card charge-offs in the U.K. are somewhat lower than in the U.S. The Canadian ABS market has grown, which allows the market to fully fund his company's credit card operations there.

A second panelist expresses concern about the credit cycle. He argues that the whole ABS market may be sowing the seeds of a credit bubble. On the international front, he expects strong demand for project financings such as toll roads. However, it remains to be seen whether those transactions will be financed through the capital markets or through the banking markets.

A third panelist notes that although the U.S. share of the global securitization pie is shrinking, it still accounts for about two-thirds. He views development of local currency markets in Asia as a key step for facilitating continued growth.

Reading the Coverage – How Transparent is Your Deal?: Regulation AB is likely to boost transparency in the ABS market. Deal documents are the key; they specify reporting obligations. The future of transparency is here, in Regulation AB. The new regulation requires many new disclosures and improved periodic reporting on ABS deals.

A second panelist feels that transparency has generally improved over the past few years. He feels that the improvement was a response to particularly weak disclosure practices in the early part of the decade. Most market participants have come to view improved transparency as a benefit. His company now refuses to buy deals unless the dealer is willing to mark the positions (i.e., provide secondary trading prices) on a monthly basis. Third-party models, such as Intex, have improved. Third party models are more frequently tied-out to dealer models. The buy-side has done well in demanding those improvements. Investors should not allow their quest for investments to undermine the progress that they have achieved in improved transparency.

A third panelist notes that the rating agencies' new interest rate stress models in the sub-prime mortgage sector are a benefit to the market.[7] However, new "affordability" products for sub-prime mortgage borrowers will increase risks for ABS investors. It now seems much easier for sub-prime borrowers to get mortgages than it was a few years ago.

A fourth panelist observes that the auto ABS market started the year with high issuance volumes and tightening spreads. Investor demand has been very strong. In 2004, there was only $80 billion of

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http://fic.wharton.upenn.edu/fic/papers/04/0403.pdf); Valuation of Life Insurance Reserves, 11 NYCRR 147 (available at http://www.ins.state.ny.us/acrobat/r147text.pdf) (implementation of Regulation Triple-X in New York).

[7] See, e.g., Kornfeld, W., *U.S. Subprime Mortgage Securitization Cashflow Analytics*, Moody's special report 17 Mar 2004); Osterweil, T., et al., *Criteria for U.S. RMBS Interest Rate Vectors Revised*, Standard & Poor's special report (29 Jul 2004).

new issuance but roughly $100 billion of amortization of outstanding deals. Auto issuance in 2005 is likely to be in the range of $75 billion to $80 billion. All the captive auto finance companies have developed alternative sources of liquidity, which could reduce ABS issuance in 2005. Some investors use the strategy of underweighting the corporate debt of the manufacturers and overweighting the bonds of the captives, which helps drive corporate spreads tighter for the captives.

A fifth panelist highlights the importance of identifying situations where the market's sentiment (i.e., fear & confidence) diverges from fundamental valuations. At times, fear has overwhelmed fundamentals and investors have mistakenly turned away from fundamental value. In contrast, some market participants now are too confident; they are ignoring weak fundamentals. He expects a correction in the next couple of years; spreads could widen by hundreds of basis points. He favors senior tranches of troubled deals over subordinate tranches of new deals.

Closing advice from panelists:

- Stay short, go for quality
- No fundamental issues in the short-term; make sure you know what you're buying
- There will be a "rebalancing" of credit spreads
- Investors should speak up about what they want. They arguably should lower their expectations for future investment returns.

9:30 am – Has the ABS Market Become Predictable? Trends, Developments and Future Outlook for U.S. ABS

How Predictable Has the ABS Market Become? Panelists have differing views about the predictability of the ABS market. One panelist feels that the underlying fundamentals appear stable and, therefore, that the market should have confidence that the status quo will be maintained. He expects the status quo eventually to be broken by an exogenous shock.

The contrary view is that overheated demand has overshadowed credit fundamentals. The market arguably is poised for a correction. Shocks like NCFE, DVI, NextCard, and Heilig-Meyers come from time to time.[8] In addition, the market now is practicing rating shopping on CDOs (excluding Moody's from certain deals).[9] Spreads today are not justified by the fundamentals.

Volume Outlook: Most panelists expect ABS issuance volumes to be flat or to decline slightly in 2005. One panelist takes a contrary view and expects home equity ABS volumes to continue growing through the first half of the year. January 2005 was a record month of issuance for the home equity ABS sector. The dominant view, however, is that home equity ABS issuance will decline, while other sectors (autos, cards, and student loans) may increase slightly.

Interest Rates: Most panelists expect the Fed Funds rate to be around 3% at mid-year and around 3½% at the end of the year. One panelist expects the Fed Funds rate to reach 4¼% by the end of the year. He is generally bullish on consumer credit. He notes that housing remains affordable. The yield on the 10-year Treasury is likely to move higher, but not by so much that it significantly hurts housing affordability.

Most panelists feel that the rising Fed Funds rate will not hurt consumers until it reaches 4½% or higher.

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[8] For background on NCFE, DVI, and NextCard see *ABS Credit Migrations 2004*, Nomura fixed income research, at 26-29, 31-32 (7 Dec 2004). For background on Heilig-Meyers see *ABS Credit Migrations*, Nomura fixed income research, at 23 (updated 5 Mar 2002).

[9] *Compare* Fender, I. and Kiff, J., *CDO Rating Methodology: Some Thoughts on Model Risk and Its Implications*, BIS Working Paper No. 163, at 10-13 (Nov 2004) (available at http://www.bis.org/publ/work163.pdf).

The labor market and home price appreciation are key factors for the credit performance of sub-prime mortgage loans. The price of oil also is an important factor. Aggressive loan underwriting and "affordability" products (interest-only loans and silent seconds) pose a risk to credit performance.

Predatory Lending: Most panelists view laws against predatory lending as an important issue. Allegations of predatory lending practices are on the rise.[10] There will be another push this year for federal legislation. One panelist feels that the market is doing a good job of keeping loans that could have assignee liability out of securitizations.

Prime vs. Sub-prime: Most panelists would prefer a deal from a sub-prime lender moving into the prime sector over a deal from a prime lender moving into the sub-prime sector. However, both investor panelists hold the contrary view and would prefer to see a deal from a prime lender moving into the sub-prime sector. One panelist points out that prime and sub-prime lending businesses are different. When a company owns both, it must run them differently and staff them differently. A sub-prime business has more safeguards. The panelist feels that the move from sub-prime to prime is inherently less risky.

A second panelist focuses on the fact that prime lenders tend to be better-capitalized than sub-prime lenders. He notes that prime lenders may have less capability in gauging risk. However, he suspects that a sub-prime lender is likely to have weaker processes and controls relating to appraisals and documentation. The low absolute levels of credit enhancement leave only a very thin margin of error in deals backed by loans to prime-quality borrowers. A third panelist notes that when a prime lender acquires a sub-prime operation it must be prepared to work through many challenges. His company acquired both a sub-prime mortgage lender and a sub-prime auto lender. The acquisition of the sub-prime mortgage lender went smoothly, but there were many problems with the acquisition of the sub-prime auto lender.

Regulation AB Compliance: Panelists generally expect that it will be difficult for issuers to comply with the requirements of new Regulation AB.[11] One panelist explains that the challenge is tough, but entirely do-able. The static pool data requirements are significant. The SEC rules will require significant business changes for many types of ABS market participants. Companies should be preparing now for the changes required by Regulation AB. Companies have until the end of this year to prepare. If they do not prepare, they will not be allowed to securitize in 2006. Companies cannot use any of the benefits of the new rules unless they comply with all of Regulation AB. Finally, proposed Rule 159 of the SEC's offering reform proposal would drastically change the process of issuing ABS by establishing securities law liability based solely on the information that investors have at the time that they make an investment decision; information delivered later would not count.[12]

A second panelist from a credit card company notes that his company plans to wait and watch what other credit card ABS issuers do with respect to static pool data before it takes any action. He expects the process to be a "sprint to the finish line" in the latter part of the year.

One issuer panelist argues that Regulation AB does not necessarily require disclosure of static pool data because it may not be material.[13] A second panelist notes that Paula Dubberly of the SEC has stated that static pool data usually is material.

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[10] *See e.g.,* Hudson, M. and Reckard, E.S., *Workers Say Lender Ran 'Boiler Rooms'*, Los Angeles Times, 4 Feb 2005 (describing allegations of predatory lending practices by Ameriquest Capital Corp. and its affiliates) (available at http://www.latimes.com/business/la-fi-ameriquest4feb04,0,7844867.story?coll=la-home-business).

[11] 17 C.F.R. §§ 229.1100-1123 (adopted in Release 33-8518, 70 Fed. Reg. 1506 at 1597-1614 (7 Jan 2005), available at http://www.sec.gov/rules/final/33-8518fr.pdf).

[12] Securities Offering Reform, Proposed Rule, Release Nos. 33-8501, 34-50624, 69 Fed. Reg. 67392, 67424, 67464 (17 Nov 2004) (available at http://www.sec.gov/rules/proposed/33-8501.pdf).

[13] 17 C.F.R. § 229.1105(b), 70 Fed. Reg. at 1603 (7 Jan 2005).

Tiering: Panelists unanimously feel that investors are failing to differentiate between high-quality issuers and low-quality issuers. However, the absence of tiering arguably is just a symptom of the low interest rates, tight spreads, and tight credit spreads. Tiering may return when spreads eventually widen. The lack of tiering creates an opportunity for smart investors to benefit from an up-in-credit trade at little or no cost.

Event Risk: Panelists have widely differing views about the likelihood that the U.S. ABS market will experience a major disruption or event such as NextCard, Conseco, or NCFE.[14] One panelist feels that improved liquidity of distressed pools and improving ease of servicing transfers will help the ABS market weather any storms that exogenous shocks might trigger. The risk of fraud is lower now because investors exercise greater scrutiny of deals – they kick the tires harder. A second panelist feels differently. He feels that the market is under-pricing risk and displaying ignorance of fundamentals. Developments in the sub-prime mortgage area, including the increasing prevalence of interest-only loans and other affordability products, foreshadow problems that will come. Liquidity (i.e. demand) from Asian investors is part of the problem.

11:15 am – Recent Regulatory Developments (Including Basel CP3), Accounting Changes & QSPE Consolidations and Implications for the Market

Basel II is a new international regulatory capital regime for banks.[15] It is designed to tie banks' capital requirements more closely to the risk of their assets. It uses external ratings as a gauge for setting capital requirements. It also uses bank's internal ratings to set the capital requirements for liquidity facilities of asset-backed commercial paper programs. The U.S. bank regulators plan to issue a domestic implementation timeline for Basel II by June of this year.

Basel II probably will apply only to about 20 banks in the U.S. – those that have significant international exposures.[16] Other U.S. banks will continue to operate under existing capital guidelines, but regulators are likely to revise those guidelines to track risk more closely to Basel II.

Quantitative Impact Study 4 is a study by the U.S. bank regulators to assess the impact of the Basel II framework on U.S. banks. The regulators asked the major banks to fill out Excel spreadsheets.[17]

The U.S. regulators issued a proposal in May 2004 about complex structured finance transactions.[18] The focus of that proposal was transactions of the type in which Enron engaged and which led to problems for certain banks. The proposal identifies principles and best practices for financial institutions that participate in complex structured finance transactions. The proposal notes that such transactions can expose institutions to heightened reputation and compliance risk. The proposal calls for an institution's board of directors to scrutinize and approve the institution's participation in complex structured financings. The proposal also provides guidelines on documentation and due diligence practices. The proposal calls on institutions to consider not only whether they will be repaid but also whether they are exposed to compliance and reputation risk in connection with complex structured

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[14] For background on NextCard, Conseco, and NCFE see *ABS Credit Migrations 2004*, Nomura fixed income research, at 23-28, 31-32 (7 Dec 2004).

[15] Basel Committee on Banking Supervision, *International Convergence of Capital Measurement and Capital Standards, A Revised Framework* (June 2004) [hereinafter "Basel II"] (available at http://www.bis.org/publ/bcbs107.htm).

[16] *See, e.g.*, Interagency Statement – U.S. Implementation of Basel II Framework, Qualification Process – IRB and AMA (27 Jan 2005) (available at http://www.occ.treas.gov/ftp/release/2005-6a.pdf); Internal Ratings-Based Systems for Retail Credit Risk, 69 Fed. Reg. 62747 (27 Oct 2004) (available at http://edocket.access.gpo.gov/2004/pdf/04-23771.pdf).

[17] Agency Information Collection Activities, 69 Fed. Reg. 63533 (2 Nov. 2004); *see also* Federal Financial Institutions Examination Council online QIS-4 materials at http://www.ffiec.gov/qis4/.

[18] Interagency Statement on Sound Practices Concerning Complex Structured Finance Activities, 69 Fed. Reg. 28980 (19 May 2004) (available at http://www.sec.gov/rules/policy/34-49695.htm).

finance transactions. The regulators received about 25 comment letters on the proposal and they expect to make the next public release sometime during 2005.

The current proposal for implementing Basel II calls for a minimum capital charge of 0.56%. Institutions are asking for a lower minimum capital charge. The industry also raises the question of what is the notional amount of a liquidity facility at any point in time. Should it be the contractual maximum amount of a liquidity facility or the actual amount of exposure?

Internal Assessment Approach: The internal assessment approach (IAA)[19] is premised on the idea that banks have internal rating systems that generally mirror those of the rating agencies. The IAA allows banks to use their own internal assessments in lieu of public ratings. However, banks must meet strict criteria in order to qualify for using the IAA. All of the U.S. banks to which Basel II would apply should qualify to use the IAA. Banks in other countries may not get to use the IAA because their regulators don't expect that they would make reliable assessments.

FAS 140, QSPE, and Legal Isolation: FASB is likely to release a new proposal for updating FAS 140 in the third quarter of 2005.[20] FASB recently decided to revert to an earlier position (from 2003) that requires using a QSPE any time that there is a partial transfer of assets on terms other than pure pro rata. Thus, QSPEs are likely to appear in many more transactions than they otherwise would have.

The issue of legal isolation unexpectedly became a top line issue in the FAS 140 project. FASB still takes the position that accountants should expect to get legal opinions on true sale and substantive consolidation as a condition to accounting sale treatment.

D1 Bifurcation Issue: The "D1" issue is under FAS 133, on the accounting treatment of derivatives.[21] The standard generally requires decomposing derivatives and marking derivatives to market. However, issue D1 was interim guidance that suspended the requirement to decompose any derivatives from any securitizations. Now, that position is being changed. Market participants will be required to decompose derivatives in most kinds of beneficial interests other than interest-only and principal-only securities.[22] For example, the residual interest in a home equity deal would be viewed as containing an embedded interest rate swap that would have to be bifurcated. If a position has an embedded derivative that requires bifurcation, the holder can elect to simply value the whole position at fair value. This issue will bear on QSPEs. QSPEs currently are allowed to hold passive derivatives, but the bifurcation requirement may jeopardize that treatment.

International Accounting Standards: Many European and Asian countries now follow IAS 39.[23] That standard is based on risk and control. In contrast, FAS 140 is based on control. IAS 39 seems to make it more difficult to achieve off-balance sheet treatment. IAS 39 considers control when a transferor has transferred *some* of the risks and rewards of an asset.

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[19] Basel II, *supra* note 15, ¶¶ 619-622.

[20] Financial Accounting Standards Board [hereinafter "FASB"], *Statement of Financial Accounting Standards No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (Sep 2000) (available at http://www.fasb.org/st/#fas140); FASB, *Project Updates – Qualifying Special-Purpose Entities and Isolation of Transferred Assets* (available at http://www.fasb.org/project/qualifying_spe.shtml).

[21] FASB, *Statement 133 Implementation Issue No. D1, Recognition and Measurement of Derivatives: Application of Statement 133 to Beneficial Interests in Securitized Financial Assets* (available at http://www.fasb.org/derivatives/issued1.shtml).

[22] FASB, *Project Updates – Beneficial Interests in Securitized Financial Assets* (available at http://www.fasb.org/project/beneficial_interests.shtml) (describing decisions of the Board meeting of 19 Jan 2005).

[23] International Accounting Standards Board, *International Accounting Standard No. 39 – Financial Instruments: Recognition and Measurement* (for a summary of IAS 39 ***see*** http://www.iasplus.com/standard/ias39.htm or http://www.iasb.org/uploaded_files/documents/8_63_ias39-sum.pdf).

FIN 46(R):[24] Sponsors of ABCP programs have already restructured their programs and presume that their efforts will be deemed sufficient when FIN 46(R) settles into its final form. FASB is still wrestling with some basic issues such as how to treat derivatives embedded in variable interests. FASB has called on the EITF to consider the problem in issue 04-7.[25]

1:45 pm – Structuring ABS/MBS Subordinates

Real Estate Speculation: There is increasing speculation in the U.S. housing market. One ABS investor prefers investor-owned properties in New York, California, or Florida to investor-owned properties in Las Vegas or Arizona. A second panelist favors strong geographic diversification of investor-owned properties in a pool. He emphasizes that investor-owned properties are not, in and of themselves, excessively risky. He becomes concerned when loans include multiple risk factors.

Interest Rates: Higher interest rates may increase both the frequency and severity of defaults on sub-prime mortgage loans. In addition, higher interest rates would squeeze excess spread in sub-prime mortgage ABS. A second panelist argues that fraud risk is a much greater concern than interest rate risk for non-real estate ABS. Most panelists agree that interest rates are likely to rise.

A potential problem for recent (2003) deals is adverse selection. The highest quality borrowers can refinance out of the deals, leaving just the weaker borrowers in the pool. The deals suffer because the high prepayments reduce the protection from excess spread without producing a corresponding reduction in losses. The subordinated tranches of the deals rely more heavily on excess spread for their protection than do the senior tranches. One panelist observes that she has raised her cumulative loss expectations for sub-prime mortgage deals. Another panelist favors deals that address basis risk with swaps over those that use interest rate caps. The swaps can provide cash flow to offset losses. Another panelist disagrees. He contends that swaps can draw excess spread out of a deal.

Interest-Only Loans: Interest-only loans are not excessively risky by themselves. The average FICO scores of borrowers on interest-only sub-prime loans tend be higher than FICO scores of regular sub-prime borrowers. However, interest-only loans often contain other risky features, such as very high debt-to-income ratios. Other affordability products, such as 40-year loans and negatively amortizing loans, are likely to become more prevalent.

Sub-prime mortgage borrowers are primarily focused on the size of their monthly payments and are not highly sensitive to the nominal rate on the mortgage loans.

New Rating Agency Interest Rate Stresses: The new rating agency models produce deals with more credit enhancement.[26] In November, sub-prime mortgage ABS deals started to get about 75 basis points of additional subordination. In sub-prime mortgage deals, double-B-rated tranches are not much riskier than triple-B-rated tranches.

One panelist criticizes the rating agencies for not using dynamic approaches that consider multiple interest rate paths. He is concerned about scenarios where a deal meets its trigger tests, allowing the release of overcollateralization, and then experiences a contraction of excess spread. The panelist likes deals that have both delinquency triggers and cumulative loss triggers. Cumulative loss triggers sometimes do not protect the subordinate tranches of a deal.

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[24] FASB, FASB Interpretation No. 46, Consolidation of Variable Interest Entities, an Interpretation of ARB No. 51 (revised Dec 2003) (available at http://www.fasb.org/fin46r.pdf).

[25] For the status of EITF issue no. 04-7 see http://www.fasb.org/eitf/eitfissu.shtml#04-7.

[26] Kornfeld, W., *Impact of Moody's Updated U.S. Subprime Mortgage Cashflow Analytics*, Moody's special report at 3 (9 Sep 2004); *see also*, Kornfeld, W., *U.S. Subprime Mortgage Securitization Cashflow Analytics*, Moody's special report 17 Mar 2004); Osterweil, T., et al., *Criteria for U.S. RMBS Interest Rate Vectors Revised*, Standard & Poor's special report (29 Jul 2004).

A second panelist contends that sub-prime mortgage ABS structures are weak because subordinate tranches can receive cash ahead of more senior tranches. In some scenarios, the most subordinate bond in a deal is the most attractive.

Credit Default Swaps on ABS: Credit default swaps (CDS) are gaining increased interest in the real estate ABS area. The definition of "credit events" remains a tough issue. For example, one question is whether reduction in distributions because of an available funds cap would constitute a credit event. ABS backed by credit cards and autos do have the problem of available funds caps, but they generally do not offer sufficiently wide spreads to be attractive to CDOs. Therefore, CDS on credit card and auto ABS are not likely to be attractive to CDOs.

Trade Ideas for 2005:

- Continue surveillance and hold steady
- There is too little tiering; be defensive; trade up in credit; the triple-B and triple-B-minus end of the home equity area is too expensive
- Subordinated credit card ABS are attractive because there is no prepayment or acceleration risk.
- Favor hybrid home equity ABS; spreads are likely to widen in 2005; high yield CDOs will get cheaper and will push ABS spreads wider; demand from Asian investors is very strong and increasing.
- Spreads are not likely to widen soon; interest-only tranches from deals backed by premium loans are attractive.

2:45 pm – Are We Ready for 2005? Non-Real Estate ABS: A Research Analysts' Roundtable

The Housing Market: One panelist is confident that the housing market will remain solid for at least the next two years. Home prices display very strong serial correlation. They are unlikely to make a hairpin turn in the short run. The rate of home price appreciation is much more likely to gradually level off over the next 18 to 24 months. However, in some areas the cost of owning a home has increased much more than the cost of renting. This strains affordability, but it is not likely to trigger a reversal in home prices before 2006 or 2007. However, prices in areas with high concentrations of investor-owned properties could turn more quickly.

A second panelist feels that there is no nationwide housing bubble. Even in hot markets, any bubbles that might exist are more likely to gradually deflate rather than to burst. Unless the labor market experiences a major setback, a gradual deceleration of home price appreciation is more likely than a bursting bubble. On the other hand, mortgage credit risk is increasing because home prices are likely to turn around gradually. Moreover, some metropolitan areas, such as Los Angeles, are particularly overheated. It is hard for ABS investors to act on particular geographic views. Instead, ABS investors can be selective with respect to seller/servicers.

Interest-Only Loans: The home equity sector is influencing non-mortgage sectors by allowing borrowers to shift debt into home equity loans. Interest-only loans often include favorable credit attributes such as higher FICO scores and higher disposable incomes. Those factors may not be fully captured in rating agency models. In addition, many interest-only loans are purchase-money loans to first-time home buyers, which can be an adverse attribute in sub-prime mortgage loans. Piggy-back seconds are another risk factor that often appears in combination with interest-only loans. Overall, interest-only loans are displaying delinquencies about 25% lower than non-IO loans. The market should consider changing the three-year trigger structure for IO loans that have interest-only periods longer than three years. Those loans may suffer a greater portion of their cumulative losses in later years, compared to other loans.

A second panelist recommends caution with respect to interest-only loans.

Double-B-Rated Tranches: The CDO bid has driven spreads to very tight levels for triple-B-rated tranches. Many issuers have started issuing deals with double-B-rated tranches (e.g., GM and Metris).[27] Some consumer finance companies have had their corporate ratings placed on watch for possible upgrades. This is a positive development for holders of the companies' ABS.

Down-in-Tier versus Down-in-Credit?: One panelist favors non-prime auto over down-in-credit trades in prime auto deals. Non-prime lenders are getting stronger while the prime lenders are getting weaker.

Relative Value: Although ABS spreads are tight by historical standards, they remain attractive compared to spreads in other fixed income sectors. Additionally, ABS have a better Sharpe ratio (i.e., returns display less relative volatility).

Top Picks: One panelist favors Metris credit card ABS because both the company and the credit card portfolio are getting stronger. Another panelist notes that Providian's credit card portfolio has shown huge improvement in charge-offs, delinquencies, and excess spread. World Financial Network (WFN) FICO scores display an upward trend. Card ABS from all three companies offer wider spreads than regular, prime-quality card ABS.

Technicals: Strong foreign demand for U.S. ABS has driven spreads tighter. Foreign investors no longer shy away from amortizing deals and deals backed by exposure to sub-prime consumers. Spreads are likely to remain tight and the strong bid from the CDO sector is likely to persist for the near term.

What Could Trigger Spread Widening?: Barring a shock on the housing front or a sudden spike in interest rates, spreads are not likely to widen soon. However, technical factors such as a decline in demand from foreign investors could cause spreads to widen.

Interest Rates: One panelist estimates that 81% of consumer debt is fixed rate. Another 13% (primarily mortgages) resets contractually. The remaining portion – including mostly credit cards – resets at the discretion of the lender. Much of the floating rate consumer debt that resets contractually is subject to periodic and lifetime adjustment caps. Thus, overall, rising interest rates may not pose a very great threat to consumers. On the other hand, sub-prime consumers may be disproportionately exposed to interest rate risk through their adjustable-rate and interest-only mortgage loans.

Another panelist notes that when certain credit card banks increased their minimum monthly payments they suffered higher charge-offs. This indicates that rising rates probably will affect consumers that have floating rate debts.

Structured Finance CDOs: One mistake in the structured finance CDO sector was the push to achieve diversification rather than a push to find attractive securities. The sector learned from its mistakes and now is more disciplined in buying ABS. CDOs have allowed many foreign investors to participate in sub-prime mortgage ABS. According to one panelist, the triple-A and triple-B tranches of structured finance CDOs are attractive. Investors should carefully select asset managers. The CDO structure is here to stay and it provides a key backstop to spreads.

Another panelist feels that the new generation of structured CDOs is much better than the older generation that had been backed primarily by manufactured housing, aircraft, and franchise ABS. The newer SF CDOs concentrate primarily on home equity ABS. Going forward, there is likely to be a greater proportion of static deals. Initial asset selection will be increasingly important. Another key feature of the SF CDO area is the ability to game the rating agency analyses (i.e., exploit the differences between the methodologies of the different rating agencies).

[27] Capital Auto Receivables Trust, Series 2004-2, Class D (BB from S&P) and Metris Master Trust, Series 2004-2, Class D (BB+ from Fitch and Ba2 from Moody's).

Bankruptcy Reform:[28] There have been many false starts on bankruptcy reform. Bankruptcy reform should not have a strong impact on consumers. It would take away a consumer's unilateral choice between liquidation and reorganization. The goal of bankruptcy reform is to force a greater proportion of consumers into Chapter 13 reorganization. However, it is probably a flawed premise to believe that many of the borrowers who have chosen Chapter 7 could have successfully reorganized under Chapter 13. On the margin, bankruptcy reform would probably be a good thing, but its impact is likely to be slight.

ABS Indices: Lehman is going to introduce an ABS index this quarter. It will include home equities, credit cards, autos, and student loans. Inclusion in the index will be limited to the largest issuers, which will produce slight under-representation of the home equity sector. Only triple-A and double-A tranches will be included because pricing single-A and triple-B tranches is too laborious. Further details of the index will be released in the next month or two.

Student Loans: There should be roughly $56 billion to $58 billion of student loan ABS issuance in 2005. However, Sallie Mae will issue somewhat less ABS in 2005 than in 2004 – roughly $22 billion for 2005. Virtually all deals backed by FFELP (i.e., federally reinsured) loans trade at the same levels. Sallie Mae commands tight levels on its private (i.e., non-federally reinsured) student loan deals and is likely to issue an increasing volume of private student loan deals. Other private student loan deals trade at a slight concession.

Many borrowers of private student loans are currently in school. Those loans generate no cash flow. It remains to be seen whether deferment and forbearance policies from the FFEL programs are generally followed in private student loans. FICO scores on private student loans tend to be very high, but the credit files are very thin.

Credit Cards: Spreads are at all time tights. Performance is strong in the credit card sector. Most of the seller/servicers are highly rated banks. Credit card spreads are stable. Corporate spreads for straight bonds and for credit default swaps (CDS) are more volatile. Straight bonds and CDS can either outperform or underperform with cyclical spread oscillations.

Auto ABS: Sub-prime auto ABS should continue to display good performance in 2005. Recovery rates on repossessed vehicles should remain strong. Prepayments likely will be stable and will depend on both defaults and new vehicle sales.

CDS and TRR Swaps for ABS: The ABS CDS market is developing more rapidly than the market for total rate of return (TRR) swaps on ABS. The push for maturation is most pronounced in the home equity ABS sector, where market participants desire to use derivatives to take synthetic short positions in certain tranches.

5:15 pm – ABS Relative Value Outlook: Lessons Learned from 2004 and Outlook for 2005

Interest Rates: Rising interest rates have the potential to squeeze both consumer credit and real estate prices. So far, only a few consumers have fallen off the edge. Consumer behavior has been very good and lenders have practiced better underwriting. Investors have been a key driver supporting better underwriting. There is not a nationwide real estate bubble. However, it is unclear how issuers will respond when real estate markets eventually soften. Further upward movements in interest rates are likely to be gradual. Greenspan's successor will have a strong impact.

[28] *See, e.g.*, Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, S. 256, 109th Cong. (1st Sess. 2005).

A second panelist expects the yield curve to flatten. He notes that the new rating agency stresses for interest rates will help to insulate deals from rising rates.[29]

Transparency: One panelist is concerned that new Regulation AB[30] will reduce the quality of information available to investors because it will set a ceiling on the level of information that issuers provide rather than a floor.

Issuers: Long Beach set aside only a little bit of time to meet with investors this week. Time slots were only a half hour long. RFC is not at the conference; it's pretty obvious why not.[31] One issuer said that it would be glad to meet, but only at the golf course on Wednesday morning (reflecting a lack of willingness to provide info). In contrast, Capital One and another issuer were very open and willing to answer investor questions. Ameriquest and New Century have very good web sites. Both are very willing to provide information and to answer investor questions.

Issuance Trends: Home equity ABS issuance is likely to slow down in 2005. Interest-only loans will back much of the volume that comes. Interest-only loans from some issuers have higher FICO scores than non-interest only loans. However, for other issuers, the FICO scores of both interest-only and non-interest only loans is the same (which is bad).

Other panelists agree that interest-only loans are not necessarily bad, but in combination with other adverse characteristics they can be very risky. Investors should focus on additional loan characteristics of interest-only loans.

Silent Seconds: Disclosure of piggy-back seconds is inadequate. The presence of piggy-back seconds often is not disclosed up front in sub-prime mortgage deals. However, if investors specifically ask, they can find out if piggy-back seconds are present.

CDO Bid: Demand for subordinate and mezzanine ABS has driven ABS spreads to very tight levels. Spreads on CDO liabilities will be a key factor in whether ABS spreads tighten or widen. If CDO liability spreads continue to tighten they will pull ABS spreads tighter as well.

Structural Features: Available funds cap risk varies from bond to bond. The forward curve appears unrealistically steep. However, rates have already moved higher than last year's forward curve implied that they should have. Accordingly, investors should consider the possibility that long weighted-average life tranches could run up against their available funds caps if interest rates rise over time. The market arguably is under-estimating the risk of the caps.

Credit Spreads: One panelist feels that spreads on triple-B-rated tranches are too tight and that tranches rated single-A and double-A offer better value. A second panelist feels the opposite. He notes that spreads on triple-B-rated tranches appear tight by historical standards but that no alternatives appear more attractive. He likes some of the new Moody's-rated double-B tranches and feels that they are structured better than bonds from six months ago. The changes to rating agency interest rate stress tests imply that today's triple-Bs are stronger than those of a year ago.

Double-B-rated ABS arguably are more attractive than corporate double-Bs. Corporate double-Bs embody greater event risk.

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[29] Kornfeld, W., *U.S. Subprime Mortgage Securitization Cashflow Analytics*, Moody's special report 17 Mar 2004); Osterweil, T., et al., *Criteria for U.S. RMBS Interest Rate Vectors Revised*, Standard & Poor's special report (29 Jul 2004).

[30] 17 C.F.R. §§ 229.1100-1123 (adopted in Release 33-8518, 70 Fed. Reg. 1506 at 1597-1614 (7 Jan 2005), available at http://www.sec.gov/rules/final/33-8518fr.pdf).

[31] Certain companies, included GMAC-RFC and CSFB, decided to focus their conference efforts primarily at the January conference sponsored by the American Securitization Forum. Those companies had either no presence or only minimal presence at ABS West 2005.

Credit Default Swaps on ABS: The market is likely to stumble and make mistakes in formulating definitions of "credit events" for credit default swaps (CDS) on ABS. The CDO sector is likely to be an important user of CDS on ABS. CDS on ABS could cause spreads to widen by effectively increasing supply. In addition, CDS could increase leverage in the system and make spreads more volatile. Some dealers already make two-way markets in CDS on specific ABS issues.

Top Concerns: One panelist is concerned about the potential of higher interest rates, more interest-only loans, and declining home prices. In addition, he worried about the possibility of an exogenous shock because there has not been one for a long time.

A second panelist is concerned about the transparency of bond pricing. Many investors are required to mark their portfolios to market on a regular basis. Bond dealers should be more helpful in supplying prices. Some dealers will price a New Century ABS but not a security from a competing dealer's program that contains 100% New Century loans.

A third panelist wishes that there were an investor-oriented forum for ABS investors. Investors seem to have less and less influence as deals are over-subscribed by a factor of five.

A fourth panelist feels having deals heavily over-subscribed reflects poorly on the market. Investors have been too quick to rush into the ABS market without gaining a full understanding of the fundamentals.

Picks and Pans:

- Spreads on ABS backed by high quality cards and student loans could tighten by 5 basis points; compare Citibank credit card ABS to corporate securities from companies rated A-1/P-1; avoid floating-rate triple-A-rated ABS because of speed issues.
- Favor non-Moody's-rated triple-B and triple-B-minus subordinates; also favor double-B tranches; some triple-B ABS CDO tranches are attractive.
- Spreads on non-Moody's-rated ABS are too wide for technical reasons; favor distressed seasoned CDOs; avoid new home equity ABS and new issue CDO mezzanines.
- Avoid home equity triple-A tranches and triple-Bs; likes HEL double-As; MH will be interesting with wide spreads and improving discipline in the sector.

Wednesday, 9 February 2005

8:00 am – The Cutting Edge of Asset-Backed Securitization – Trends, Opportunities & Pitfalls

Trends: The securitization market is dynamic and continually evolving. Market participants cannot necessarily see the "uncertainty" that could bring change, but it is still there. The market started with issuers who needed funding for their assets. Later, investors became the dominant players in the market; they could get very wide spreads for triple-A risks. Today, the securitization market arguably is a trader's market. Today, traders arguably are the dominant class of market participants and are the ones in the best position to exploit the market's dynamism.

Trends – Credit: There is very strong liquidity for leveraged loans. About two-thirds of leveraged loans are making their way into CLOs. Strong liquidity arguably is bailing out companies that should fail. Thus, the market may be sowing the seeds of the next credit crisis. On the consumer front, the level of consumer debt is very high but the monthly debt burden is not too onerous. Slowing home price appreciation may eliminate homeowners' ability to continually refinance their credit card purchasers into cash-out home equity loans.

Trends – Regulation AB: We are in a period of change for securities regulation in the U.S. Regulation AB[32] creates a big compliance issue for the securitization sell side. New disclosure requirements, including static pool disclosure requirements, will force issuers to upgrade their systems. Issuers will be required to disclose five years of static pool data. Issuers will need to gather the data, create web sites to deliver the data, and develop procedures for identifying which particular information is material for each deal.

A panelist from a major auto issuer feels that the burden for his company of gathering static pool data will not be very onerous. Essentially all the data already exists in servicing reports on the company's old deals.

Opportunities – Whole Loan Trading: Many traders are becoming issuers as well as buyers of many asset classes. In the past, only mortgage loans traded in "whole loan" form. Today, auto loans regularly trade as whole loans.

Panelists debate whether whole loan sales should provide "capital relief" for loan originator/sellers. Some contend that loan sales should yield capital relief and some contend that it should not.

Improved liquidity for subordinate non-real estate ABS is important because it helps support the development of whole loan trading. The key is that whole loan buyers need to have an economical securitization exit strategy for their whole loan purchases.

Panelists distinguish between a "liquid market" and a "hot market." A liquid market is one that preserves liquidity through difficult environments. A hot market is one that simply appears liquid because of temporary market conditions (i.e., the illusion of liquidity).

Opportunities – Synthetic ABS: There are standardized synthetic indices on corporate credits: the Dow Jones CDX and its various sub-indices. The synthetic indices give investors a tool to express negative views by buying protection. Some market participants attempt capital structure arbitrage by buying a given tranche and selling the tranche immediately senior to the first tranche. Customized synthetics other than the standardized index products are much less liquid and display much wider bid-ask spreads.

Opportunities – New Asset Types: The heyday of new asset types is probably over. Market participants have already identified the vast majority of asset types that can readily be securitized. This is visible through the shrinking volume of the private placement ABS sector, which formerly had been the "laboratory" for new asset types.

Pitfalls – The Credit Cycle: Conditions today resemble those of 1992-1993. The market is in a good phase of the credit cycle right now. Credit cycles are likely to get shorter rather than longer. There is a consensus that spreads will widen later this year as interest rates rise. Many investors are selling home equity ABS; CDOs are the main buyers. One panelist sees several large bid lists of home equity ABS each week.

Pitfalls – Operating Risk: According to a recent S&P survey, operating risk is a significant concern of market participants. Operating risk is higher in some kinds of deals, such as revolving structures and equipment leasing deals.[33] Investors should carefully scrutinize small seller/servicers. A small company may embody a high level of operating risk. Servicing transfers never happen as smoothly as they are supposed to happen. Servicing transfers often cause some measure of collateral impairment.

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[32] 17 C.F.R. §§ 229.1100-1123 (adopted in Release 33-8518, 70 Fed. Reg. 1506 at 1597-1614 (7 Jan 2005), available at http://www.sec.gov/rules/final/33-8518fr.pdf).

[33] Sheridan, J., Operating Risk Analysis Strengthens Ties Between Structured and Corporate Finance Sectors, Standard & Poor's special report (15 Sep 2004).

The securitization industry is in danger of having a false sense of security about operating risk and other potential risks. The current strong environment encourages that false sense of security. Transparency and integrity are not the same thing. Improved reporting requirements can improve transparency, but they are unlikely to cure a lack of integrity.

Pitfalls – Securities Offering Reform: Proposed Rule 159 is a potential pitfall for the securitization industry.[34] The SEC has a different view of liability for term sheets than most industry participants have. Industry participants believe that a final prospectus corrects deficiencies in a term sheet. The SEC's view, embodied in Rule 159, is that the final prospectus does not matter because it comes after the investor has made his investment decision. It remains to be seen whether the SEC ultimately adopts Proposed Rule 159 in its current form. If it does, it would trigger major changes in the way in which ABS are offered. Rule 159 could curtail the use of term sheets and result in less information flowing to investors.

9:15 am – Exploiting Opportunities in the Primary and Secondary Markets: The Traders' Roundtable

The moderator challenges: The market seems "priced for perfection." Spreads seem very tight. Can they tighten further?

Spreads: One panelist agrees that the market appears priced for perfection. In particular, spreads on fixed rate home equity ABS are at levels that seem to ignore extension risk. In the floating rate home equity ABS area, spreads have widened slightly from the tightest levels of January. Spreads are unlikely to widen for either fixed rate or floating rate home equity ABS during the year.

A second panelist feels that financial assets generally are rich. The prospect of rising interest rates means that investors should favor short duration instruments.

About 75% of all ABS are floating rate. That makes it hard to use ABS to take a long-term fixed rate position. Technical factors contribute strongly to the tight spreads on the supply of those products. One panelist argues that investors should use last-cash flow bonds, subordinate tranches of certain home equity deals, and rate reduction bonds to get long durations.

CDOs in the ramp-up phases are driving tight spreads on subordinate home equity ABS tranches. Investors should particularly scrutinize the structural nuances of double-B tranches. A second panelist is concerned about the strong level of demand from leveraged players. He believes that as the yield curve flattens, demand will wane as carry-trade investors withdraw. He prefers purchasing seasoned bonds in the secondary market to buying new issues in the primary market. He places a high value on a deal's actual performance history and on the benefit of seasoning and de-levering.

Credit Default Swaps (CDS) on ABS: A hot new area is credit default swaps (CDS) on ABS. Investors currently can buy or sell protection on individual deals – mostly subordinated home equity or credit card ABS. Dealers are starting to use standardized forms of trade confirmations, which help to improve the liquidity of the CDS. By buying or selling CDS on ABS, investors can take short positions in ABS and can take long positions in larger sizes than may be available in cash instruments. Investors can use CDS to execute "capital structure" trades where they take a long position in one tranche of a deal and a short position in another tranche of the same deal. One panelist feels that the tightening of spreads on home equity ABS double-B tranches is partly attributable to capital structure trades.

Panelists have differing views of whether there are better opportunities in strategies that use CDS of ABS or in ones that focus on secondary trading of seasoned ABS. CDS of ABS help hedge fund

[34] Securities Offering Reform, Proposed Rule, Release Nos. 33-8501, 34-50624, 69 Fed. Reg. 67392, 67424, 67464 (17 Nov 2004) (available at http://www.sec.gov/rules/proposed/33-8501.pdf).

managers justify higher fees because they use both long and short strategies. Another use for CDS of ABS is to hedge specific name risks associated with CDO equity tranches.

One panelist suggests that investors should ask dealers for prices on both cash and synthetic positions whenever they consider buying a position. But, the synthetic market inherently focuses on small positions. The next evolutionary step for CDS on ABS will be the creation of CDS on baskets of ABS – similar to the Dow Jones CDX for corporate bonds.

Interest-only Sub-Prime Mortgage Loans: In many deals, interest-only loans have compensating factors such as higher FICO scores. One panelist recommends caution in bidding deals with two-year interest-only loans and deals with more than 20% interest-only loans. He recommends careful scrutiny of older deals with high concentrations of interest-only loans and essentially re-rating them in light of newer rating agency standards. Another panelist feels that there is an inappropriate lack of tiering among deals with different concentrations of interest-only loans and different kinds of interest-only loans. Deals contain too many idiosyncratic features to permit rapid analysis and comparison. The apparent absence of tiering is partly explainable by too many bonds on too many bid lists and not enough time to analyze them.

Manufactured Housing: One panelist feels that deep discount manufactured housing ABS can be attractive. For example, some of the deals from Oakwood will use up their credit enhancement and the senior tranches will suffer defaults. However, that makes the senior tranches effectively become pass-throughs and purchasing them at a discount essentially amounts to getting additional credit enhancement. Other panelists agree. However, bond-by-bond analysis is necessary for trading distressed securities.

Predatory Lending: According to one panelist, the ABS market is shrugging-off last week's accusations of predatory lending violations against Ameriquest.[35]

10:15 am – Structured Finance CDOs: An Investor/Issuer Roundtable

Do Structured Finance CDOs Work? Where is the Arbitrage?: Panelists disagree about whether structured finance CDOs can be executed on a profitable basis at current tight spread levels for structured finance assets. One panelist contends that careful asset selection can produce a profitable deal. Another feels that CDO equity returns are too slim now. CDO equity investors should not accept mid- to high-single digit projected returns. The debate ultimately centers on whether a deal's sponsor can find an equity investor that will accept a return that makes a deal profitable.

Structured finance CDOs from the 2001 vintages did not work because they got caught in the storm of problems that afflicted the manufactured housing and aircraft ABS sectors. Diversification did not protect those deals. Today's deals, in contrast, are highly concentrated in residential assets (MBS and real estate-related ABS); they are not diversified across structured finance sectors.

According to one panelist, one way to "make the arb work" is to buy securities that are overrated. He contends that some triple-B-rated home equity ABS are simply "double-Bs in drag." He argues that triple-As available at unusually wide spreads do not deserve to carry triple-A ratings. Another panelist criticizes the practice of booking distressed ABS at par but approves carrying them in a CDO at purchase price.

Investors should differentiate among managers. Investors should consider where managers have put their own money at risk. Investors should focus on whether managers have a disciplined approach to evaluating assets for a CDO portfolio. One panelist argues that investors do not focus sufficiently on manager quality in deals backed by high-grade assets. Another panelist emphasizes the importance

[35] Hudson, M. and Reckard, E.S., *Workers Say Lender Ran 'Boiler Rooms'*, Los Angeles Times, 4 Feb 2005 (describing allegations of predatory lending practices by Ameriquest Capital Corp. and its affiliates) (available at http://www.latimes.com/business/la-fi-ameriquest4feb04,0,7844867.story?coll=la-home-business).

of choosing managers that operate in areas where they possess expertise. Even so, a manager migrating down-in-credit from high-grade faces tougher challenges than one migrating up-in-credit from high-yield.

Managers need to develop strong internal controls and reliable processes. Managers also need to have financial resources. Managers should be able to survive for extended periods without printing new deals at inopportune times. A manager should be committed to the business, not just to the next deal.

As a sector, structured finance CDOs may be particularly sensitive to the interest-only sub-prime mortgage loans. It is somewhat troubling that interest-only sub-prime mortgage loans were accepted so quickly into sub-prime mortgage ABS even though they did not have a performance history. Rating agencies and investors probably would not have been so quick to accept the introduction of similarly risky features into credit cards or other consumer asset classes. Structured finance CDOs may suffer badly if interest-only sub-prime mortgage loans end up performing substantially worse than expected.

Some dealers encourage managers to issue static deals as a way to break into sectors where they lack experience. Panelists criticize the practice. A manager's abilities matter in static deals because structuring and initial asset selection are critical, and ongoing monitoring and credit sales require substantial expertise.

Credit Default Swaps on ABS: One of the biggest challenges for credit default swaps on ABS is defining credit events. Another area that raises challenges is settlement mechanics. However, the advantages of CDS on ABS are so compelling that the market is likely to overcome the challenges in order to develop an efficient and liquid market for synthetic ABS.

The absence of issuer tiering in today's market arguably creates opportunity for using CDS to act on negative views of certain issuers.

The corporate CDS market grew exponentially once it overcame the challenge of creating standardized documentation and settlement mechanics. Panelists expect the ABS CDS market to grow similarly once it overcomes its challenges.

Choosing an Underwriter: In choosing an underwriter, one CDO manager focuses on how active a potential underwriter is in supplying collateral. Another manager focuses on an underwriter's reputation. A third manager focuses on an underwriter's willingness to remain active in the CDO market through market cycles and dislocations. Managers seem to de-emphasize distribution abilities in selecting underwriters.

Thursday, 10 February 2005

8:00 am – State of the Alternative/Private Student Loan Market

Private (alternative) student loan originations have been increasing because of the combined effect of rising tuition and static loan limits under the federally re-insured loan programs. In contrast to federally-reinsured loans, private student loans are credit products. Private student loans are not dischargeable in bankruptcy if originated by a non-profit entity. One proposal for re-authorization of the Higher Education Act[36] later this year would raise the loan limit for freshmen to $3,000 from $2,625, which has been the limit since the 1980s.

[36] 20 U.S.C. § 1001 et seq., Pub. L. No. 89-329, 79 Stat. 1219, as amended.

There are several different categories of private student loans. A loan to a graduate student generally is not co-signed by the borrower's parents; but the borrower has some credit history. In contrast, about 90% of undergraduate loans have cosigners. K-12 lending is growing. "Career" loans (i.e., loans to students in non-degree granting programs) is a new and challenging area. Understanding the credit risk profile of the potential borrowers is critical in structuring a program. Private consolidation loans are a new area and they have generated much interest in the market. However, a private consolidation loan entails tough credit analysis because the borrower is underwater and is looking for 25 year unsecured credit.

The Loan Process: A family completes the application and the federal government determines the expected family contribution. Then the school financial aid office determines the students net financial need based on the expected family information. Stafford loans are need-based, not credit based. PLUS loans are not based on FICO scores but the lenders do look for derogatories on the credit report (such as bankruptcies). Loan proceeds are disbursed directly to the school. Sallie Mae expects to originate $3 billion to $4 billion of alternative student loans in 2005.

Rating Considerations: Many prospective issuers of private student loan ABS are start-up operations with no performance history. S&P views the absence of performance data as an obstacle.[37] To overcome the obstacle, S&P develops projections based on the performance of FFELP (federally re-insured) loans, with the added feature that private loans have credit underwriting. A source of uncertainty comes from allowing exceptions to credit underwriting criteria. Moreover, it is hard to predict how a new company is going to handle deferment and forbearance situations. Accordingly, S&P imposes a conservative bias in projecting expected losses for a new company's private student loan originations. S&P considers the experience of the management team and looks for managers with a background in consumer lending. In FFELP servicing, the objective is to preserve the guarantee. In servicing private student loans, the objective is to maximize collections. What is the loan delivery channel: through financial aid offices or direct to consumers? What is the originator's motivation: profit or non-profit? Is the private loan a "loss leader" for the originator's FFELP business?

Trustees' Role: The private student loan sector is now following the lead of other ABS asset classes in using independent trustees to provide data warehousing, servicer report verification, and collateral agent/custodian services. The role that is evolving the most rapidly is the backup administrator role. In that function, an independent trustee verifies servicer reports and makes sure that cash is being applied correctly. The expanding roles for trustees in private student loan deals are an extension of practices that developed in the sub-prime auto and home equity sector in response to ABS defaults several years ago.

PLUS loans and private student loans essentially fill the same need. In a PLUS loan, the parent feels the need to pay for the child's education. In a private student loan, the parent may be a co-signer but the child is the primary obligor. In a private student loan, the *student* needs to borrow because his parents are unable or unwilling to finance his education with PLUS loans or otherwise.

Most private student loan borrowers (or their parents) have high FICO scores. However, there is a trend to expand the business to lower-FICO score borrowers. With appropriate risk-based pricing, those loans can be profitably originated and financed through securitization (with more credit enhancement).

FICO scores are a tool for credit underwriting private student loans. However, credit score migrations arguably are even more important than initial scores because of the long-term nature of student loans. A student's education is an appreciating asset and a student's ability to repay his loan tends to increase after graduation and as he establishes himself in his career.

[37] Student Loan Criteria, Standard & Poor's (1999).

Some major companies, including CIT, MBNA and Countrywide, have announced plans to get into the private student loan business.

Private student loan servicers are still working out the best servicing strategies with respect to forbearances. A positive servicing practice is to require every student to go through exit counseling at the end of school. Today it is hard for a student loan borrower to skip because modern skip-tracing practices make it easy to find them. Sallie Mae has acquired a number of collection companies over the past few years.

Panelists cannot say how frequently lenders have to garnish the wages of borrowers who default on the private student loans.. Although FICO scores are tuned for maximum predictive power over a two-year time horizon and student loans are longer-term obligations, FICO scores still provide an adequate tool for rank-ordering risk and applying risk-based pricing.

— E N D —

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NOMURA

NEW YORK	TOKYO	LONDON
Nomura Securities International	Nomura Securities Company	Nomura International PLC
2 World Financial Center, Building B	2-2-2, Otemachi, Chiyoda-Ku	Nomura House
New York, NY 10281	Tokyo, Japan 100-8130	1 St Martin's-le-grand
(212) 667-9300	81 3 3211 1811	London EC1A 4NP
		44 207 521 2000

David P. Jacob 212.667.2255 International Head of Research

Nomura U.S. Fixed Income Research

David Resler	212.667.2415	Head of U.S. Economic Research	James Manzi	212.667.2231	CMBS Research/Strategy
Mark Adelson	212.667.2337	Securitization/ABS Research	Elizabeth Bartlett	212.667.2339	Analyst
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